Sayonara Yen – It's Different This Time

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Amongst all the worries about rising uncertainty, it is reassuring to see that some relationships still hold strong and steadfast. Japanese equities have been extremely correlated[1] to the currency, with yen appreciation forcing negative stock performance, and yen depreciation forcing Japan outperformance. In recent weeks, that relationship has been holding stronger than ever; Japanese stocks have become a top global market performer, moving in lock-step with the accelerating depreciation of the Yen. This cycle confirms once again, to capture Japan's upside[2], dollar-based investors should continue to hedge[3] the currency.

More importantly, this cycle has further to run; the risk of a domestic political backlash against yen depreciation is significantly reduced by the up-turn in domestic nominal wages and incomes, in sharp contrast to the slowdown observed in 2015. In my personal view, yen depreciation towards new decade lows of ¥130-140/$ has become possible, which in turn suggests at least a 20-30% upside to Japanese equities from here.

No, No Change – Yen Weakness to Force a Better-Than-Consensus Positive Earnings Cycle

For analysts, the time-honored inverse equities-to-currency correlation is simply matter-of-fact; as almost two-thirds of listed companies' corporate profits are generated from exports or overseas production, yen currency cycles are the natural dominant swing variable for earnings cycles. How much? Our calculations suggest that for every ten-yen of yen depreciation, profits get pushed up by as much as 10%.

[1]Correlation: Statistical measure of how two sets of returns move in relation to each other. Correlation coefficients range from -1 to 1. A correlation of 1 means the two subjects of analysis move in lockstep with each other. A correlation of -1 means the two subjects of analysis have moved in exactly the opposite direction.
[2]Upside: Currency appreciation.
[3]Hedge: Making an investment to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract.

For investors today, the rock-solid link between earnings and currency has one major implication: Japan is poised for a much better than expected corporate earnings upcycle. Why? Both analysts and corporate CFOs are still basing their forward-looking estimates on an average ¥103-105/$ for the current fiscal year 2016 (ends March 2017), i.e. a level that now looks much too conservative.

Specifically, if the yen averages ¥115/$ from here, profits could surge by as much as 20% against the 9-10% currently expected by consensus forecasters. Add to this the fact that Japanese equities valuations[4] are still attractive; TOPIX[5] currently runs on 15.6x consensus earnings, a significant discount[6] against its ten-year average of approximately 18x. A 20% rise in profits puts TOPIX on about 13.5x – very much at the bottom range of historic valuations.

All said, even after the recent run-up, the combination of attractive valuations and rising earnings visibility is poised to create substantial tailwinds for Japanese equities. Blue-chip exporters are poised to emerge as more decisive outperformers in coming months, in our view.

Yes, It's Different This Time

There are two primary differences between the last yen-depreciation cycle and now: rising wage growth and Bank of Japan (BOJ) rate targeting.

The first one is domestic; nominal wage growth is now accelerating. In contrast, wage growth began to decelerate shortly after the "Kuroda Bazooka" of October 2014 pushed the yen below ¥110/$ and started the previous depreciation cycle. Nominal workers' compensation had accelerated to a decade-high 2% growth at the start of 2015, but plunged a mere 1.2% growth by Q3 2015. This deceleration of nominal wage growth in 2015 had a significant negative impact on the domestic policy debate and public attitudes towards yen depreciation. While a weaker yen is good for corporate profits, it also creates imported inflation[7], which in turn reduces the real purchasing power of the people. Low-income earners are disproportionately affected negatively, because food prices are the most immediately impacted by a weaker yen.

By the end of 2015, the combination of the import-cost-push inflation rise and corporations not passing on the profit windfalls from yen depreciation to higher wages, de-facto created a political backlash against yen depreciation in Japan in 2015. Prime Minister Shinzo Abe's failed attempts to persuade corporates to raise wages fueled fears amongst his team of advisers that a weaker yen would open a rising gap between "haves and have nots," which in turn could undermine Abe's popularity. Make no mistake – as Team Abe was preparing for the Upper House election at the end of 2015, a weaker yen was not the backdrop they wanted, in our view.

Now, one year later, fortunes have turned. The tightness in the labor market is beginning to pull up wages and incomes, and nominal workers' compensation growth has re-accelerated to 2.5% by Q3 2016; exceeding not just the previous high but the highest growth rate in over a decade. All indications are that demand for labor keeps rising against increasingly scarce supply.

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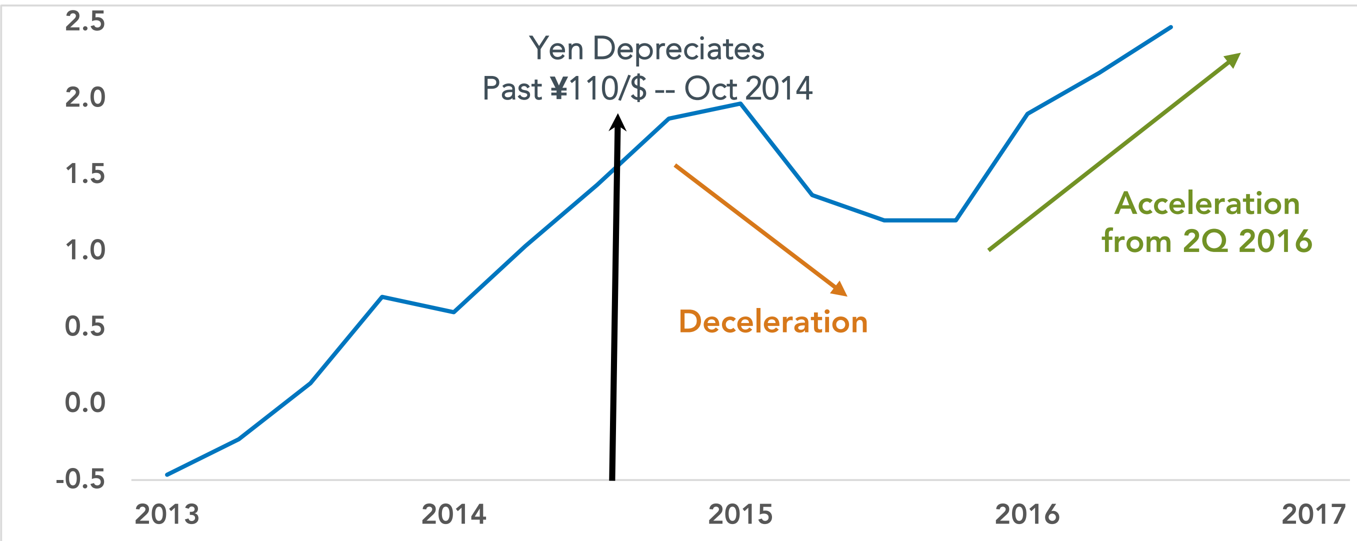
[4]Valuation: Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.
[5]Tokyo Stock Price Index (TOPIX): A free float-adjusted market capitalization-weighted index that is calculated based on all the domestic common stocks listed on the Tokyo Stock Exchange First Section.
[6]Discount: When the price of an ETF is lower than its NAV.
[7]Inflation: Characterized by rising price levels.

Make no mistake – this acceleration in nominal wage and income growth has created a significant buffer. The risk of a domestic political backlash against further yen depreciation today is much lower than it was twelve months ago, in our view. Moreover, for next year, Team Abe has taken out some insurance; effective 2017, companies that raise employment will get a tax cut.

Re-acceleration of Nominal Wage Growth Created Buffer Against Yen Depreciation Political Backlash



Sources: WisdomTree Japan, Bank of Japan. From Q1 2013 to Q3 2016, with 2017 projected estimates.

BOJ Now "Passive Aggressive," Not a "Pro-Active Aggressive" Currency Manipulator

The second difference is the fundamental driving the yen lower. The last round of yen depreciation was triggered by the "Kuroda[8] Bazooka" when, at the end of October 2014, the BOJ decided to basically double its asset purchases and quantitative easing[9] program. At the same time, the public pension fund GPIF[10] announced a significant shift in asset allocation targets, switching out of domestic bonds into global securities and domestic equities. In other words, the previous round of yen depreciation was proactively triggered by aggressive Japanese policy makers pushing for yen weakness. As such, Japan was running high risks of accusation of being a "currency manipulator" by the U.S.

In contrast, the current currency move is clearly triggered and accelerated by the growing desynchronization of U.S. and Japan interest rates: The Federal Reserve (Fed) is starting to raise U.S. rates while the BOJ is committed to anchoring Japanese interest rates at zero. By doing nothing but the orthodox targeting of domestic interest rates, the BOJ has turned "passive aggressive"; the yen is not pushed, but pulled down as the Fed creates conditions for a stronger dollar. As such, Japanese monetary policy makers have significantly mitigated the risks of a U.S. political backlash and being branded a "currency manipulator," in our view.

All said, we believe the depreciation of the yen has further to go, with significantly positive implications for further outperformance by Japanese equities. If, as I suspect, the 2017 Fed rate-hike[11] cycle exceeds expectations, dollar upside to ¥130-140/$ should come into sight, in my personal view. The political and policy backdrop in Japan certainly suggests a much greater tolerance for yen depreciation.

It is both tolerance and desire, in my view; current BOJ leadership is under pressure to achieve the 2% inflation target before the race for the next BOJ Governorship appointment intensifies in early 2018 (the current five-year term expires in March 2018). Reappointment to a second term is possible; whether Kuroda will get a second term or not will be decided by one person: Abe. In our view, Abe's basic philosophy appears to be straightforward: members of his team get rewarded if they meet their targets. The pressure to perform is on, and without the yen depreciating past ¥120-125/$, both arithmetic and economics suggest hitting anywhere close to 2% inflation is impossible.

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[8] Haruhiko Kuroda, Governor of BOJ

[9] Quantitative Easing (QE): A government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital, in an effort to promote increased lending and liquidity.

[10] Government Pension Investment Fund (GPIF): Japan's largest public pension fund.

[11] Rate Hike: refers to an increase in the policy rate set by a central bank. In the U.S., this generally refers to the Federal Funds Target Rate.

Unless otherwise stated, data sources are WisdomTree.

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